Why Schumpeter got it Wrong in *Capitalism, Socialism, and Democracy*

Herbert Gintis

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1 Introduction

Joseph Schumpeter's *Capitalism, Socialism, and Democracy* is above all an exercise in prediction. Born in the English Industrial Revolution and thrust into prominence by its successes in France, Germany, and the United States, capitalism had existed for more than a century when Schumpeter began to assemble the material for his book. Socialism had a much shorter history. A constant theme in workers' movements, socialism first became tangible through the establishment of the Soviet economic system scarcely twenty-five years before Schumpeter wrote. Despite this disparity in age, and with no empirical indication of the newcomer's practical viability, Schumpeter boldly proclaimed socialism the new order, while judging capitalism as doomed to extinction.

The power of Schumpeter's argument was immediately apparent to his contemporaries. By both supporting capitalism and predicting its inevitable demise, Schumpeter established himself as a true iconoclast. He moreover abandoned the two central intellectual reference points around which the capitalism-socialism debate had traditionally turned: on the one hand philosophical arguments concerning the validity of historical materialism, and on the other hand economic arguments concerning the viability of the command economy. Having no need for general theories of history, Marxian or liberal, Schumpeter rejected the former pure and simple; and being quite confident in the ability of the socialist economy to operate efficiently, he sided unequivocally with Enrico Barone and the socialists in their famous dispute with the arch-defenders of private property, Friedrich Hayek and Ludwig von Misses.

Yet if, with Schumpeter, we define socialism as collective property and planning by public authority (Schumpeter 1942, p. 415) then his major thesis has not been historically vindicated. Indeed, not only does capitalism continue to flourish, but state socialism in this traditional sense is ever more harshly questioned even in societies which have historically been its most passionate supporters. In Schumpeter's words, socialism is "that organization of society in which the means of production are controlled, and the decision on how and what to produce and on who is to get what, are make by public authority instead of by privately-owned and privately-managed firms."

Where did Schumpeter go wrong? The answer to this question is of more than theoretical interest. Indeed, addressing this issue may clarify both the future of democracy and the probable nature of the next series of challenges the capitalist economy is likely to face.

In this paper I shall suggest the following explanation of Schumpeter's error. Schumpeter's attention in *Capitalism, Socialism and Democracy* is single-mindedly focussed on one question: under what conditions can creative and effective leadership emerge in political and economic systems? For this reason, his discussion of socialism vs. capitalism ignores the traditional terms of debate (the morality of private property, the feasibility of state planning, the role of market vs. plan), and evaluates the survivability of the two systems solely on the basis of their ability to generate competent and innovative entrepreneurship. Similarly, Schumpeter defends political democracy not on the traditional grounds of protecting liberty and generating decisions reflecting the general will, but rather on its capacity to generate competent and creative political leadership.

In Schumpeter's economic theory, competitive markets serve as a mechanism for identifying competent firm leadership. The viability of state control of the economy, he concludes, flows from his opinion (shared by many of his aristocratic contemporaries appreciative of the accomplishments of constitutional monarchies) a that rational bureaucracy is no less capable than market competition of assessing and rewarding competence.

But Schumpeter has a faulty theory of social leadership. While correctly stressing the contribution of the personal qualities of leaders to their performance (integrity, intelligence, creativity, managerial ability, devotion to duty, and the like) he virtually ignores the equally important contribution of the *structures of external accountability* to which leaders are subjected. This systematic oversight explains the relative weakness of Schumpeter's defense of political democracy in comparison with more traditional defenses. Democracy's chief strength in fact is not its ability to identify leadership qualities, but its ability to render the powerful *accountable for their actions* through the institutions of freedom of expression and information, due process, and periodic elections. Since no other known political system exhibits this strength, it is reasonable to consider political democracy a necessary condition of good government. For Schumpeter, by contrast, democracy is not *necessary to*, but merely *compatible with*, good government.

Ignoring the contribution of structures of external accountability also explains Schumpeter's overestimation of the viability of state socialism. While careful to distinguish the 'public authority' controlling the economy from the rest of the state apparatus, and while mindful of the need for general state monitoring of this 'public authority' [Schumpeter (1950):168-169], Schumpeter never entertains the possibility that an undemocratic state might be incapable of effective oversight of the economy simply because it is unaccountable to the general public. And while it is currently fashionable to attribute the failure of state socialism to its excessive reliance of plan over market and moral over material incentives, I consider it likely that its inadequate structure of accountability of the state apparatus is a stronger explanatory factor.

His lack of concern for structures of accountability is also implicated in Schumpeter's uncritical agreement with the socialists on the issue of the feasibility of a planned, non-market industrial economy.[1] On this point Schumpeter could hardly be more clear:

> [S]olution of the problems confronting the socialist management would be not only just as possible as is the practical solution of the problems confronting commercial managements: it would be easier. [Schumpeter (1950):186]

His reason for the increased ease of socialist management is a most revealing expression of Schumpeter's world view:

> [O]ne of the most important difficulties of running a business... consists in the uncertainties... about the reaction of one's actual and potential competitors and about how general business situations shape... [Under socialism] these two can reasonably be expected to vanish almost completely. [Schumpeter (1950):186]

The existence of massive capitalist firms with concentrated autocratic leadership does indeed show the possibility of extensive centralized non-market planning, but Schumpeter here overlooks the fact that *market competition provides a structure of accountability considerably limiting the range for abuses of power on the part of corporate leaders*. Schumpeter's vision of an economy operating effectively in the absence of the market, and with no vision of a replacement for the market as a structure of accountability, is a fatal error.

[1] In a footnote in his famous "The Use of Knowledge in Society," written shortly after the publication of Schumpeter's book, F. A. Hayek claims that "Professor Schumpeter is... the original author of the myth that Pareto and Barone have "solved" the problem of socialist calculation."

I will not bore the reader with a list of capitalism's many flaws. The fact that Schumpeter was wrong will surely not end the search for a superior form of economic organization. The collapse of state socialism around the world may have blinded people temporarily to this fact, but capitalism has not seen its final challenge. Yet the wrong lessons must not be learned by those aiming to contribute to an alternative. We may not conclude that the current capitalist system is optimal, that private property in the means of production is desirable or inevitable, or that the search for a more democratic and egalitarian economic system is futile.

The collapse of state socialism should rather convince us of the critical need for structures of accountability to which holders of power are subject in both economy and government. Democratic political institutions solve the problem of governmental accountability, and are otherwise generally desirable. The competitive market economy provides a workable solution to the problem of economic accountability, has some other desirable properties (e.g., it promotes individual choice), but has numerous less desirable implications. Some of these can be mitigated by effective state intervention, but the search for structures of economic accountability which complement and/or supplant market mechanisms (e.g., labor-managed firms and expanded community control of credit and investment) must continue.

2 Schumpeter's Theory of Bureaucratic Leadership

Schumpeter based his projection of the coming victory of socialism on what he considered the inevitable bureaucratization of capitalist life, removing from the capitalist class its *raison d'etre*. "Technological progress, notes Schumpeter,

is increasingly becoming the business of teams of trained specialists who turn out what is required and make it work in predictable ways. [Schumpeter (1950):132]

As a result, he continues,

The romance of earlier commercial adventure is rapidly wearing away...The perfectly bureaucratized giant industrial unit...ousts the entrepreneur and expropriates the bourgeoisie as a class... [Schumpeter (1950):134]

This movement, Schumpeter argues, is moreover the inexorable product of capitalist development itself; and socialism follows, since the bureaucratic state is the appropriate social instrument for the management of an inherently routinized economy:

The capitalist process, by substituting a mere parcel of shares for the walls of and the machines in a factory, takes the life out of the idea of property....Dematerialized, defunctionalized and absentee ownership does not...call forth moral allegiance...Eventually there will be *nobody* left who really cares to stand for it–nobody within and nobody without the precincts of the big concerns. [Schumpeter (1950):142]

Schumpeter does not here renounce his theory of creative entrepreneurship as the basic source of economic growth. Rather, he argues that this creative activity is increasingly bureaucratized, and hence can be fostered by mechanisms other than the capitalist market system. In particular, private property is no longer naturally part of the social mechanism by which individuals gain access to positions of economic power, since the technical and management experts most capable of modern entrepreneurship need not possess personal wealth. From the functional theory of social stratification, of which Schumpeter was one of the first proponents, it immediately follows that the capitalist class is doomed to extinction.

If, however, competence and expertise must not only be *identified* but also *rendered accountable*, Schumpeter's conclusion as to the superiority of socialism does not follow. Schumpeter's political theory, we shall see, suffers from a similar flaw.

3 Schumpeter's Defense of Political Democracy

Schumpeter's preoccupation with leadership is evident in his stance toward democratic governance. It is precisely this preoccupation that bids him reject the 'classical doctrine' that

the democratic method is that institutional arrangement for arriving at political decisions which realizes the common good by making the people itself decide issues through the election of individuals who are to assemble in order to carry out its will. [Schumpeter (1950):250]

In this classical doctrine, Schumpeter argues,

the selection of the representatives is made secondary to the primary purpose of the democratic arrangement, which is to vest the power of deciding political issues in the electorate. [Schumpeter (1950):269]

However any such notion depends "on the proposition that 'the people' hold a definite and rational opinion about every individual question," (p. 269) which Schumpeter considers blatantly inaccurate. Rather, Schumpeter asks,

Suppose we reverse the roles of these two elements and make the deciding of issues by the electorate secondary to the election of the men who are to do the deciding. [Schumpeter (1950):269]

The result is a theory of political competition for leadership in which "the role of the people is to produce a government." (p. 269) Capitalists do not produce out of love for either production or the economic well-being of their employees or customers, but rather for profits. Similarly, in a democratic system so politicians produce legislation and administer the affairs of state not from abstract conviction, but rather from the desire to maintain and improve their political position:

in order to understand how democratic politics serve this social end, we must start from the competitive struggle for power and office and realize that the social function is fulfilled, as it were, incidentally–in the same sense as production is incidental to the making of profits. [Schumpeter (1950):282]

In the classical conception of politics such a model of the political process would have been seen as crass and opportunistic. Schumpeter clearly recognizes this fact:

Many exponents of democratic doctrine have striven hard to divest political activity of any professional connotation. ...But this is just ideology.....“What businessmen do not understand is that exactly as they are dealing in oil so I am dealing in votes.” [Schumpeter (1950):285]

Just as Mandeville and Smith recognized that “private vices” might become “public virtues” through the medium of competitive exchange, so Schumpeter asserts the compatibility of the “bottom line” of electoral success with creative political leadership. The competitive theory of democracy, he claims

leaves all the room we may wish to have for a proper recognition of the vital fact of leadership. The classical theory... attributed to the electorate an altogether unrealistic degree of initiative which practically amounted to ignoring leadership. [Schumpeter (1950):270]

In sum, Schumpeter's political theory is a defense of political democracy against the charge that the inherent mediocrity of the masses must entail the mediocrity of democratic leadership. Schumpeter thus claims that political democracy is *compatible with* good government. But never does he claim that democracy is a *necessary or sufficient condition* for good government. In this respect Schumpeter parallels his assessment of capitalism and socialism: private property and markets are compatible with, but neither necessary nor sufficient for a well-functioning economy.

4 The Analytical Roots of Schumpeter's Error

There is a close analogy between Schumpeter's treatment of market and electoral competition. As in the case of his treatment of the capitalist economy, in the case of the democratic state the quality of leadership is central, and the structure of competition (electoral or market) merely a contingent means towards its achievement. So much is evident from his treatment of the preconditions of successful democratic government, which concern not the rules of the game, but the character of the players:

Democracy thrives in social patterns that display certain characteristics... the human material of politics... should be of sufficiently high quality... the effective range of political decision should not be extended too far... [it] must be able to command... the services of a well-trained bureaucracy... [and] electorates and parliaments must be on an intellectual and moral level high enough to be proof against he offerings of the crook and the crank, or else men who are neither will be driven into the ways of both. [Schumpeter (1950):291-294]

The weakness in this statement is its presumption that the quality of leadership is a property of the agent in power, whereas in fact it depends critically on the types of accountability to which the leader is subjected as well.

The basic presumption of Schumpeter's analytical framework is what may be termed the *revelation principle*, which includes the following beliefs:

(a) Most individuals when asked, reveal the truth, either through inclination (a sense of basic honesty) or through the threat of penalties for dissimulation;

(b) It is not excessively costly to devise laws and social norms which enforce and encourage such behavior, at least when such laws and norms enjoy widespread legitimacy; and

(c) It is not excessively difficult to identify honest individuals, and to detect deviations from truthfulness that may arise in the course of their performing their social functions.

The revelation principle is incorrect. Moreover capitalism, like representative democracy, does not rely on the revelation principle, while state socialism cannot achieve a reasonable level of efficiency and innovation without it.

The revelation principle is incorrect for two reasons. First, it incorporates an inadequate conception of individual behavior, which may be termed the *normal-deviant opposition*. The "normal' individual in this conception has been properly socialized to operate according to approved norms, and the contrasting "deviant" individual has imperfectly incorporated social norms.[2] In place of this normal-deviant opposition, I propose that the individual social actor treats laws and social norms as *obstacles to* and *tools for* the achievement of a set of goals which are influenced by, but not reducible to, the socially approved.

The revelation principle, second, underestimates the extent to which the character of individual action is *opaque and private*. Laws cannot adequately specify social obligations because, except in the most egregious cases (theft, murder, embezzlement, falsification of documents, fraud, and the like), the criteria of 'socially correct' behavior are normally more subtle than can be captured in a regulation, a contract, or a law, and are in addition highly susceptible to dissimulation.[3]

Economists generally model individuals as maximizing their preferences subject to constraints. Traditionally preferences have been treated as self-referencing,

[2]This notion was formalized in structural-functional sociology. For a critique, see Gintis (1975), and Bowles and Gintis (1981). For statements our alternative view, see Bowles and Gintis (1986,1990)

[3]See Becker and Stigler (1974), Gintis (1980), and Bowles and Gintis (1990).

constraints have been treated as budget constraints, and the context has been limited to market exchange. In recent years these restrictions have been lifted in a variety of ways. Altruism and ethical goals can be integrated into preferences, constraints can be extended to include moral strictures as well as civil and criminal penalties, and the context can be extended to include family relationships and government (Buchanan et al. 1980, Axelrod 1984, Bowles and Gintis 1986, Bowles and Gintis 1988, Bowles and Gintis 1993).

For our purposes, the most important aspect of this new literature is its dropping the assumption that information passed from one agent to another will be chosen solely according to moral and scientific conceptions of veracity and truth. Rather, agents pass information to one another so as to best achieve their personal goals (Holmstrom, 1979; Laffont and Maskin, 1982; Hurwicz, 1985; Bowles and Gintis, 1991), subject of course to whatever constraints are imposed by society and their own ethical standards. The importance of market competition in this framework is not that of the efficient allocation of goods, but the disciplining of agents and the eliciting of correct information.

Markets avoid reliance on the revelation principle by rendering economic actors accountable for the *results* of their actions rather than for the actions themselves. The owner of a small business, or the manager of a corporate enterprise must pay homage to the bottom line: either the firm earns profits and she is a saint, or it looses money and she is a dog. Similarly, a worker's fate in the capitalist firm depends directly on whether the firm can do better by replacing her. No law or bureaucratic regulation need be violated to dismiss an employee; no evidence need be gathered and no cogent list of charges need be compiled. It is simply the worker's responsibility to convince the employer that she is adequate to the task. In short, the market provides as potent structure of accountability, in which the agent is presumed guilty unless proven innocent.

In the state socialist economy, planners are expected to act in the public interest, managers are expected to innovate and produce efficiently, and workers are expected to do their best on behalf of the enterprise and in the larger interest of society. When asked, planners are supposed to reveal their actions and intentions to government authority, managers are supposed to divulge the true conditions of production and opportunities for innovation, and workers are supposed to reveal both the actions they have taken and the personal goals which motivate their choices. Were the revelation principle correct, and in the presence of the proper system of laws, regulations, and internal checks and balances, this would be sufficient to ensure the accountability of economic agents. But it is not.

Now Schumpeter is certainly correct in noting the rise of the bureaucratic firm in advanced capitalism, and the corresponding tendency for the tight linkage between ownership and control characteristic of early capitalism to be ruptured. Indeed, this was the major theme in Berle and Means' famous *The Modern Corporation and Private Property*, which appeared a decade before Schumpeter's *Capitalism, Socialism, and Democracy*. But Schumpeter, like Karl Marx before him, erroneously located the survival capacity of capitalism with a *class*, that of entrepreneurial capitalists, rather than with a set of *rules of the game*: competitive labor, capital, and product markets which render agents accountable for the results of their actions.

It is perhaps not surprising that Schumpeter should err in this direction. In Schumpeter's time, traditional economics extolled the virtues of the market as system for the rational pricing of goods and their efficient allocation in static equilibrium. Schumpeter, by contrast, considered static efficiency, and hence the market, as secondary to the creative, disequilibrating activity of the owner-entrepreneur. With the decline of individual ownership, the core of capitalism and hence its basis for survival would, according to Schumpeter, thus simply vanish. Traditional economics may have incorrectly stressed the contribution of markets to allocational efficiency, but it did not err in asserting the centrality of markets to the success of capitalism. By placing his faith on the efficacy of undisciplined bureaucracy, Schumpeter overlooked the key point that market competition is the basis of capitalism's survival value by virtue of its capacity to render economic agents to a significant extent accountable for the results of their actions.

Similarly, electoral competition is far less contingent to the successful operation of government in modern society than Schumpeter suggests. Its attractiveness in fact flows directly from the fact that *representative democracy avoids reliance on the revelation principle*: elected officials retain their offices by the grace of their constituency. The basic power of the electorate, as Schumpeter suggests, is precisely *the right to switch*, without the need for proof of malfeasance or even negligence. The power of democracy is that no law or bureaucratic regulation need be violated to secure the ejection of an official from office. The politician is accountable in the direct sense that it is her responsibility to convince the electorate that she is adequate to the task of governing. Neither due process nor presumption of innocence stands between the elected official and the displeasure of the electorate.

5 Conclusion: New Issues in Political Economy

Markets are allocational mechanisms. But markets are also disciplinary mechanisms, altering the supplies of inputs and technologies, and thus shifting the production possibility frontier. Many critiques of market allocations concern the inefficiencies which arise in the presence of external economies and economies of scale, while arguments against state intervention often focus on the problems of the effective monitoring and disciplining of economic agents in the absence of market competition. We have been traditionally asked to choose between the allocational irrationalities of markets and the motivational and disciplinary shortcomings of the state.

The choice is in fact less stark. The allocational and disciplinary aspects of markets, often thought to be inseparable, are not. Despite the ragings of free market dogmatists, there is clearly a wide range of economic arenas in which allocational inefficiencies can be significantly attenuated through regulation and tax-subsidy policies without impairing the disciplinary function of the market.

Moreover, the idea that markets discipline may help identify economic arenas in which markets might effectively be superseded by non-market mechanisms, and conversely. Since the question involves the supersession of a structure of accountability, it is most natural to search for alternatives that implement *democratic economic accountability*. The quest for such an alternative plunges us immediately into the central issues of theory of agency. Take the governance structure of the firm as a case in point.

The modern firm faces two crucial problems of agency: how to handle the money of outsiders and manage the labor of its members. The capitalist firm as a particular solution to these two problems. By comparison with the currently feasible alternatives (for example democratically-run worker-owned cooperatives) I have elsewhere argued that the capitalist firm is a relatively poor solution to the labor agency problem and a relatively attractive solution to the credit and investment agency problem (Bowles and Gintis, 1990).

Among advocates of economic democracy, however, the problems investment and credit are generally given scant attention, while the internal management of the democratic firm is widely studied. The omission is serious in its own right, and distorts the analysis of democratic alternatives to the capitalist firm. For some organizational forms which might have attractive properties from the standpoint of the democratic regulation of labor impinge in unfortunate ways on attractive solutions to the agency problems associated with the allocation of capital (Gintis, 1989a,b).

The joint commitment to democracy and efficiency thus raises a dilemma: some degree of external control of the firm by non-members may be justified by its contribution to efficiency and to a socially optimal level of risk taking; but external control of the firm compromises the principle of the democratic accountability of power. The reasons why a degree of external control may be long run efficiency enhancing are clear enough: due to the incentive incompatibility surrounding the extension of credit, the absence of external control (by lenders or investors) will discourage investment in the firm, and the inability of worker-owners to diversify their assets will lead, in the absence of external control, to insufficient risk taking.

But the compromise of democratic principles entailed by external control is no less transparent than its economic advantages: the **democratic** argument for workers controlling their conditions of employment does not extend to creditors controlling the use to which their assets are put, since creditors are not generally long side agents, and hence do not face agents having power over them.

What form, then, might an alternative to the capitalist credit market take? If we reject the option of a central planning board for reasons outlined above, we must devise a decentralized credit allocation mechanism which provides a structure of accountability, yet does not undermine the democratic organization of the firm by locating ultimate control in outside agents whose only interest in the firm is financial.

One solution is to recognize that the capitalist stock market combines three functions which in a democratic economy could be separated: it allocates investment funds to firms, it determines who owns and controls firms, and it generates useful information concerning the expected future performance of firms. A democratic alternative can render investment and control of the enterprise democratically accountable, while leaving the generation of information to a competitive market process, by supporting an 'information industry' in which agents collect and reveal knowledge concerning the future economic performance of firms, while neither directly investing in nor controlling these firms. Such an industry might operate on the model of football pooling or horse racing, in which 'point spreads' and 'odds' are determined by a competitive bidding process, while the participants have no direct stake in the financing, ownership, or control of the contesting parties. The following is a sketch of one such possible institution.

Consider a 'pseudo stock market' that deals in the purchase and sale of pseudo-shares in the various firms operating in the economy. Participants in the pseudo stock market buy and sell these pseudo-shares at competitive market-determined prices. At appropriate intervals the government's Securities Agency disburses payments to stockholders in proportion to the profitability of the firms that their stocks represent.[4] Stockholders who correctly forecast enterprise performance thus enjoy an increase in their expected future payments and hence in the prices of the stocks they hold. Demand for the stocks of firms that stockholders on balance expect to do well will thus increase, and the price of these stocks will rise in anticipation of future returns.

Such a pseudo stock market is a form of parimutual betting, in which the contestants are firms, the criterion for winning is profitability, the bettors are financial

[4]These payments could be financed by general taxation, or by a profits tax on firms. In the latter case, the role of the government as an intermediary could be eliminated, and firms could be directed by law to pay a specific share of their profits to stockholders.

investors, and the endogenously determined odds are relative stock prices. As in parimutual betting, the odds reflect the expected performance of the contestants while *the bettors have no direct control over the strategic behavior of the contestants themselves*. This pseudo stock market reproduces the information-gathering function of the capitalist stock market, in that changes in stock prices embody useful information concerning the future performance of firms. This information, along with considerations of environmental balance, equity, and other objectives, can be employed by government, community, and private investment agencies to allocate investment funds to firms.[5] Yet, it does not entail the unaccountability of power characteristic of the capitalist stock market.

This sketch of an alternative to the traditional capital market is no more than suggestive and partial. Certainly provision must be made for the financing of small firms, enterprises that require extensive entrepreneurial risk-taking and innovation, and non-profit organizations. Similarly, environmental issues, regional balance, and the like must supplement the criterion of profitability in the allocation of investment funds, and the overall rate of growth must be governed by criteria relatively independent from competitive pricing and performance. It does illustrate, however, how one might formulate the search for an alternative to market allocation that increases democratic accountability without relying on the idealized conception of the economic agent reflected in the revelation principle underlying Schumpeter's poor showing in assessing the future of capitalism, socialism, and democracy.

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[5]Of course if the overall rate of return to pseudo stock market activity were nonpositive, it would be irrational for agents to gather information, and participation would be no more than an idle pastime. But the Securities Agency can set dividends so that the average return to stock market investments is sufficient to call forth an adequate level of information-gathering activity.

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